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BY THE U.S. GENERAL ACCOUNTING OFFICE

Report To The Chairman Of The National Credit Union Administration

The National Credit Union Administration Should Revise Liquidation Procedures To Reduce The Net Cost Of Credit Union Liquidation

The number of liquidations that must be performed by NCUA has increased sharply in recent years. Reducing the net cost of liquidations is clearly one policy the NCUA Board can pursue to enable the share insurance fund to better cope with the strains that may lie ahead.

Although NCUA has made recent efforts to reduce the cost of liquidations, GAO believes more needs to be done. NCUA could reduce the net costs of liquidation by maximizing the value of the loan portfolio and reducing expenses. In addition, GAO believes more active NCUA supervision is needed to insure compliance with policies intended to reduce the net cost of liquidations.

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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

GENERAL GOVERNMENT
DIVISION

B-202546

The Honorable Edgar F. Callahan
Chairman, National Credit Union
Administration

Dear Mr. Callahan:

GAO has completed most of the audit work associated with our review of the conduct of financial institution liquidations by the National Credit Union Administration (NCUA) and the other Federal agencies that insure financial institutions. Since NCUA is actively considering changes in its liquidation programs, we are issuing this letter so that our views may be available to you during your deliberations.

We are pleased with NCUA's recent efforts to improve the management of the National Credit Union Administration Share Insurance Fund (NCUSIF, also referred to as the fund). More still needs to be done, however, to deal with the main problem addressed in this report--reducing the net cost to the fund of liquidating a credit union. We estimate that in 1980 NCUSIF recovered from liquidation proceeds only about 60 percent of the outlays it incurred in liquidating credit unions. NCUA's net losses for both voluntary and involuntary liquidation activities totaled about $27.6 million in 1980. Although it is difficult to make precise estimates, we think that implementation of the changes already adopted and of those recommended in this report should enable NCUA to reduce the loss rate from liquidations by as much as 20 to 30 percent from that which we observed in 1980.

OBJECTIVES, SCOPE, AND METHODOLOGY

We performed this review to assess the economy and efficiency of NCUA's program to liquidate failed institutions. Our review focused on NCUA's involuntary liquidations from 1972 through 1980. Our objectives were to examine

--overall management of liquidations, including staffing, contracts, accounting, and oversight;

--control over assets, including valuation, marketing, monitoring, and disposition; and

--appropriateness of expenses incurred.

We reviewed NCUA's written policies and procedures and discussed them with officials in headquarters and NCUA's Region II, Harrisburg, Pennsylvania; Region III, Atlanta, Georgia; and Region VI, San Francisco, California. These three regions account for about 50 percent of the assets acquired by NCUA during 1979 and 1980. We obtained statistics on involuntary liquidations accounting for over 77 percent of the assets involved in the involuntary liquidations in two of those regions. NCUA officials agreed with estimates we developed for asset recovery, payment of uninsured liabilities, and the cost to conduct involuntary liquidations because NCUA records for that period did not provide the necessary data.

Our review did not examine NCUSIF administrative activities associated with such areas as financial assistance, mergers, and loan collections. In 1980 these administrative activities cost the fund about $12.4 million, roughly one quarter of the $53.5 million received by the fund in that year from assessments and interest on investments. This review also excluded audit of NCUSIF's financial statements which were the subject of a recent GAO report. 1/

In addition to compliance with policies established by the NCUA Board and with sound financial management principles, we applied two other criteria to our evaluation of NCUSIF activities. They were:

--The extent to which policies or practices minimize a liquidation's net cost to the fund.

--Consistency with current Federal Deposit Insurance Corporation (FDIC) and Federal Savings and Loan Insurance Corporation (FSLIC) policies and practices. FDIC and FSLIC, respectively, provide deposit insurance for banks and savings and loan associations.

1/"Opinion on Financial Statements of the National Credit Union Administration" (AFMD-81-102, October 2, 1981).

We were particularly concerned with reducing the net cost of liquidations because the number of liquidations that must be performed by NCUA has increased sharply in recent years. Forecasts for 1982 indicate that fund expenses will exceed income that year for the first time since the fund was established. We have not attempted to evaluate the overall financial outlook for the fund, but reducing the net expense of liquidations clearly is one policy the Board can pursue to enable the fund to better cope with strains that may lie ahead. Although consistency with the practices of FDIC or FSLIC is not required, we have used this criterion because we believe it reasonable that common practices be adopted unless there are overriding reasons why they should be different.

RECENT EFFORTS TO REDUCE THE NET COST OF CREDIT UNION LIQUIDATION

The net cost of liquidation represents the difference between what NCUSIF pays for share insurance and administrative expenses and what the fund gets back from insolvent credit union assets. In 1980 NCUSIF paid out $67.5 million--$60.0 million for share insurance and an estimated $7.5 million 1/ in administrative expenses. NCUSIF received $39.9 million from disposal of assets resulting in a net liquidation cost of $27.6 million.

During the course of our review we identified a number of problems with how NCUSIF was managed that contributed to making the $27.6 million net liquidation cost as high as it was. NCUA has recently made a number of changes that should, however, help to reduce the net cost of liquidation. Chief among these are the following:

--NCUA eliminated the requirement that a legal ad announcing the loan sale be placed in a local newspaper, reduced

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1/NCUA's budget officer estimates 90 percent of all NCUSIF expenses classified as overhead and insurance expenses result from liquidation activities. Applying this figure to the $6.2 million in overhead expenses and $2.7 million in insurance program expenses results in an estimated administrative expense associated with liquidation of $7.5 million. This $7.5 million expense involves both voluntary and involuntary liquidations. About 21 percent of liquidations are voluntary and the associated workload is less than the workload on involuntary liquidations. For purposes of this report we have assumed that about $1.5 million of the $7.5 million is associated with voluntary liquidations.

the number of days to advertise for bids from 30 to 15, and emphasized to the regions that timely sales of loans have equal priority with timely share insurance payouts. Since the value of the loan portfolio falls sharply as loan delinquencies rise, these actions to accelerate loan sales should increase the proceeds from loan sales and reduce the net cost of liquidations.

--In August 1981, the Board adopted a policy to offset the shares of member or co-maker accounts against loans that are 30 or more days delinquent. This policy will reduce fund payouts and the amount of net loss. In one region we had calculated that over 10 percent of delinquent loan value could have been recovered by offsetting unpledged shares against delinquent loans. The Board also approved share to loan transfers on accounts of $50 or less with the right of reversal if the loan is current. Before this policy was adopted, liquidation procedures for very small loans were not cost effective.

--In 1981, NCUA eliminated most loan servicing activities at headquarters by selling the 23,000 loans it was attempting to service or by placing them with collection agencies. Future loans not sold in the regions will also be placed with collection agencies rather than sold to headquarters. Since NCUA did not have enough staff to service loans, only 10 to 15 percent of which were current, this new policy should increase loan recovery and reduce NCUA expenses.

--In August 1981, the Board adopted a policy to allocate all costs incurred in liquidation to individual cases and authorized a contract for improving cost and expense data collection so that the policy can be implemented by March 1982. Although the Federal Credit Union Act provides that reimbursement of expenses should be given high priority in the allocation of the proceeds from insolvent credit union assets, we estimated that in 1980 NCUA charged to individual cases only $100,000 of the estimated $7.6 million 1/ in

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1/The $7.6 million includes $100,000 charged to liquidations and the $7.5 million that was not allocated. The $100,000 consists of expenses incurred in the regions for items such as legal ads, postage, and temporary labor. The $7.5 million consists of administrative expenses paid from the fund, primarily the costs related to NCUA employees.

administrative expenses that could have been allocated to individual cases. The new policy should eliminate much of the loss to the fund incurred in conducting voluntary liquidations, which was estimated to be about $1.5 million in 1980, and it should also reduce net losses from many involuntary liquidations.

--NCUA recently implemented improved cash management measures to ensure that regions comply with guidelines limiting liquidation account cash balances to $5,000. NCUA also plans to implement a centralized disbursement and receipt account system by March 1982. NCUA internal audit and our own work both demonstrated that thousands of dollars were being lost due to excessive cash balances in liquidation accounts.

These steps that NCUA has taken reflect concern for reducing the net cost of liquidations. There are additional steps that NCUA should also take to accomplish this objective.

NCUA SHOULD TAKE ADDITIONAL STEPS TO MAXIMIZE THE VALUE OF THE LOAN PORTFOLIOS OF INSOLVENT CREDIT UNIONS

The net cost to the fund has been large primarily because the sale value of loan portfolios, a credit union's largest asset category, has been substantially less than book value. We estimate that 1980 liquidation proceeds of $50.1 million amounted to about two-thirds of the book value of the assets of the credit unions being liquidated. For loans, which comprised about 70 percent of the assets in liquidation, the recovery averaged approximately 60 percent.

By changing policies and conscientiously implementing newly enacted policies, NCUA should realize an average return higher than 60 percent on loans. Obtaining the maximum possible recovery from loan portfolios is essential in reducing the net cost of liquidating credit unions. In 1980, a 10-percent increase in the amount realized from loan portfolios would have reduced NCUA's net cost of liquidations by about 15 percent.

Finance companies should be allowed to bid on loan portfolios

NCUA's past experience has shown that expanding the market results in higher yields from the sale of loan portfolios. Interest among potential buyers increased substantially following an April 1980 Wall Street Journal article describing NCUA procedures for selling loan portfolios. Before the article, regions would informally contact a few potential buyers to solicit bids, and advertisements were placed in local papers that had very

limited circulation. Frequently only one or two bids were received; in most cases the bids were below the acceptable minimum bid and the portfolios were sold to NCUA. Many potential buyers now request routine receipt of registers of future loan sales, and since April 1980 nearly 78 percent of the loan portfolios in the three regions we reviewed were sold to private buyers.

In November 1977 NCUA discontinued loan sales to finance companies because it believed finance companies would attempt to refinance the loans at higher interest rates--an action that contradicts credit union philosophy of providing loans at lowest possible rates. Up to that time finance companies had been top bidders and seldom requested guarantees.

In December 1980 the Board reaffirmed this policy. Given the need to create the widest possible market for loans of liquidated credit unions, we believe NCUA should not exclude an entire category of potential buyers. If individual finance companies or any buyer attempts to pressure members of the liquidated credit union into refinancing loans or otherwise does not comply with provisions in the loan portfolio sale contract, NCUA can eliminate them from future sales.

One region wrote in 1980:

> "There appears to be a lot of interest in alternative means of financing the purchase of loan portfolios as well as alternatives to the collection methods utilized by the purchasers. A vast, new market appears to be forming for the disposition of loan portfolios and we suggest NCUA consider these proposals carefully."

We agree with this statement and are encouraged by NCUA headquarters' efforts to improve procedures concerning loan sales. To develop the widest possible market for loan portfolios, however, we believe that policies prohibiting sales to finance companies, which represent a large segment of the potential market, should also be changed.

Recommendation

The NCUA Board should drop its prohibition against sales of loans to finance companies.

Greater efforts should be made to preserve the value of assets before credit unions become insolvent

Maximizing the value of the assets of insolvent credit unions involves more than adopting new procedures to be followed after a credit union becomes insolvent. NCUA must also direct attention to what happens before the liquidation begins. Much of the deterioration in the value of a credit union's loan portfolio can take place prior to the time the credit union enters liquidation.

NCUA has recently required that examiners insure that credit union records are in balance prior to liquidation. In order to preserve the value of a failing credit union's assets, we believe NCUA should also do everything possible to insure that loans have complete documentation, collateral is properly assigned and controlled, shares are pledged in accordance with NCUA regulations, member and co-member shares are frozen on delinquent accounts, and all possible collection efforts on delinquent loans are actively pursued. To accomplish this, NCUA could consider changing its informal and formal supervisory powers to preserve the value of the loan portfolios of failing credit unions. There are several ways that this could be done. For example, one alternative would be for NCUA to allow less time for credit unions to respond to deficiencies found in supervisory examinations. Another option would be earlier use of more formal actions such as cease and desist orders.

Recommendation

The Board should adopt policies to preserve the value of assets before credit unions actually become insolvent.

NCUSIF'S CLAIM AGAINST LIQUIDATION PROCEEDS SHOULD BE EQUAL TO THAT OF GENERAL CREDITORS

The Federal Credit Union Act provides for reimbursement of NCUA liquidation expenses from the proceeds of insolvent credit unions' assets. The act is not specific, however, about the priority to be given to reimbursing NCUA for share insurance expenses. A 1978 opinion from NCUA's General Counsel stated that the share insurance fund, along with uninsured share accounts, should have the lowest priority of payment to insure the stability of credit sources for credit unions. Accordingly, general creditors are paid before the share insurance fund is reimbursed, which in effect provides 100-percent insurance for all credit union liabilities.

The effect of NCUA's priority of payment policy can be illustrated using data from 1980 liquidations. In 1980 NCUA realized $50.1 million from the disposal of assets but only $40.0 million was used to reimburse NCUSIF. The $10.1 million not paid to NCUSIF was paid to fully reimburse all credit union creditors. If NCUA practices had been the same as FDIC's, NCUSIF and creditors whose claims were not secured by pledged assets would have shared in a pro rata distribution of liquidation proceeds. This means that some of the $10.1 million paid to creditors in 1980 would instead have been paid to NCUSIF, thereby decreasing the fund's net liquidation cost.

The Board has been reluctant to change its payment priority schedule but is undertaking a study of the monetary gain to be realized if the priority is changed. The largest group of credit union creditors are other credit unions that, given sufficient notice, would be in a position to secure their claims, thereby guaranteeing payment before NCUSIF and general creditors. It is, therefore, difficult to predict exactly what net effect a change in NCUA policy would actually have. However, it would seem that changing the payment priority could only be beneficial to NCUSIF. If all creditors were not able to secure their claims, changing the policy to conform to FDIC practice would help to reduce the cost of liquidations. Even if most creditors are able to secure their claims, the discipline of NCUA requiring borrowing credit unions' boards of directors to formally approve such arrangements should help prevent credit unions from becoming overextended on credit. Such formal procedures would also help NCUA in its regulation of credit unions.

The Board is apparently also concerned that changing the priority of payment policy may make it difficult for credit unions to get credit and could force them into liquidation. We appreciate NCUA's concern for the practical effects of a change in payment priority. However, NCUA officials have not demonstrated that credit union finances are so fragile that solvency of a substantial number of credit unions depends upon liquidation procedures that serve to provide a 100-percent Government guarantee for all credit union liabilities. For liquidity purposes, credit unions can borrow from the National Credit Union Central Liquidity Facility or a Federal Reserve Bank's discount window if other sources of credit are not available. Thus, we believe there is little justification for NCUA to use a priority of payment schedule different from that used by FDIC.

Recommendation

Assuming that share accounts can be treated as deposits for insurance purposes, the NCUA Board should revise the priority of payments to place the share insurance fund on an equal basis with general creditors.

PROCEDURES FOR UNCLAIMED LIABILITIES AND UNCLAIMED SHARES SHOULD BE CHANGED

NCUA has developed a system in which all unclaimed liabilities and shares are placed in trust accounts when a credit union liquidation is terminated. We believe NCUA could reduce its losses on liquidations and eliminate unnecessary bookkeeping by changing procedures to limit the time a liability or share has a priority claim.

Unclaimed liabilities should not be trusteed

NCUA deposits the amount of full or pro rated unclaimed liabilities in a noninterest-bearing trust account when a credit union's charter is canceled. Unclaimed liabilities often include small accounts, outstanding or unpresented checks, and unidentified and unlocated items. Trusteeing these accounts coincides with the termination of the liquidation effected by canceling the credit union's charter. Termination is at least 4 months after the date the credit union enters liquidation. Until early 1981 all unclaimed liabilities were trusteed without any discretion as to the item or the dollar value. A March 1980 listing of trusteed accounts included nearly $59,000 in 174 accounts that could not be identified to an individual. NCUA now plans to delete these items from the system and to not enter any unclaimed liabilities that cannot be identified to an individual.

FDIC's practice is to bar the rights of creditors to payment after giving creditors notice and a reasonable period of time has passed. We believe any liabilities not claimed when the credit union's charter is canceled at the termination of the liquidation should be eliminated. This would allow NCUA to reduce expenses and unnecessary recordkeeping.

Recommendation

The NCUA Board should limit the right for creditors to claim liabilities to the date of charter cancellation.

Procedures for unclaimed shares should be simplified

Although NCUA attempts to locate all credit union members, some unclaimed shares remain in voluntary and involuntary liquidations. The Federal Credit Union Act states that any member of a closed credit union failing to claim his insured account within 18 months forfeits his rights to the claim. NCUA interprets the legislation as allowing unclaimed share deposits to be reduced by a pro rata distribution of expenses at the end of 18 months.

Until recently, unclaimed share deposits were placed in a noninterest-bearing Treasury account, but NCUA revised its policy in August 1981 to retain unclaimed deposits in the fund. The records for these accounts are sent to a contractor who services the accounts and notifies NCUA when to escheat funds to States in accordance with local laws. As of March 1980, there were 48,477 trusteed accounts totaling $913,724. By December 31, 1980, NCUA had an additional 429 cases with 26,548 accounts waiting to be trusteed.

Insurance for unclaimed deposits in failed commercial banks also expires at 18 months, but FDIC handles these deposits differently from NCUA. FDIC assigns unclaimed deposits a rank in the priority of payment schedule below reimbursement of FDIC for all liquidation expenses. As the liquidation matures and FDIC determines that itself and all creditors will be paid in full, FDIC will escheat the unclaimed insured deposits to those States with applicable laws. If FDIC projects a loss on the liquidation, nothing is paid on unclaimed insured deposits and further claims are barred. In addition to reducing the loss on liquidations, this procedure also eliminates the administrative burden of maintaining these accounts.

Recommendations

The NCUA Board should

--give unclaimed share deposits a lower claim on liquidated credit union assets than NCUSIF reimbursement; and

--escheat unclaimed funds to the States after 18 months.

For those unclaimed funds already placed in a trustee account, we further recommend NCUA dismantle the existing system of trusteed share and liability accounts in a manner consistent with our recommendations for unclaimed shares and liabilities. We recognize the records may not be sufficient to make such an effort cost effective, in which case we recommend the funds be escheated to the States.

MORE ACTIVE NCUA SUPERVISION IS NEEDED TO INSURE COMPLIANCE WITH POLICIES INTENDED TO REDUCE THE NET COST OF LIQUIDATION

NCUA is responsible for monitoring liquidation progress, providing funds for payouts, managing loans that cannot be sold, handling unclaimed shares and liabilities, counseling on legal matters, and canceling charters after completion of all liquidation actions. As the number of liquidations increased in recent years, NCUA regional offices conducting liquidations have given

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priority to activities that affected shareholders--principally paying off shares. Activities that did not affect individual shareholders received lowest priority and frequently were not performed in accordance with established criteria. We are concerned that accomplishment of NCUA's objective to reduce the net cost of liquidation may be jeopardized by failure of the NCUA regional offices to give sufficient priority to this objective.

The lack of NCUA controls is evident even in the payout of shares. NCUA headquarters provides no standard for regional office compliance with the legal mandate to conduct cash payouts as soon as possible, and regional offices have therefore drafted their own standards. During 1979 and 1980, the three regions we reviewed averaged 16 days from the date of liquidation to complete 221 payouts. Of the 136 liquidations in 1980, however, 75 took between 15 and 41 days to complete.

In the key area of marketing loans, the NCUA manual for conducting involuntary liquidations allows regions to take 60 days to sell loans to a private bidder or, if they could not be sold, to sell the loans to headquarters. We found this standard was often not met. In 1979 and 1980, the three regions we reviewed averaged 92, 64, and 53 days to sell loan portfolios. Of the combined total of 201 loan portfolios sold, over 43 percent took between 60 and 234 days to be sold. As described above, the value of a loan portfolio falls sharply as delinquencies rise. If the policies NCUA recently adopted to enable it to move more quickly in selling and servicing loans are not implemented with more consistency than the 60-day standard, efforts to reduce the net cost of liquidations will be significantly impaired. In addition, we believe that under newly adopted NCUA policies this standard should be reduced to no more than 45 days.

In our review of liquidations we noted other areas where regional office performance did not comply with NCUA standards. For example, in the 92 cases that both entered liquidation in 1980 and had forwarded unclaimed shares to headquarters, only 16 made the transfer within the 90-day period specified in the involuntary liquidation manual. Compliance with the requirements to cancel charters within 5 months from the date of involuntary liquidation unless unusual events occur has been very poor. Our most recent financial audit 1/ also showed that NCUA headquarters had not paid trusteed accounts to the Treasury in accordance with established procedures.

1/"Improvements Needed in the Accounting and Financial Management of the National Credit Union Administration" (AFMD-82-21, December 16, 1981).

These instances of inconsistent standards and failure to meet performance guidelines suggest that the NCUA has not supervised liquidation activities closely enough. Particularly with respect to activities needed to preserve the value of the assets of liquidated credit unions, it is essential not only that proper policies be adopted but also that they be implemented properly.

NCUA has recognized shortcomings in its management of the liquidation activities. The NCUA headquarters organization and functions were revised in October 1980 and May 1981 to improve overall program management and coordination, and a new position was established specifically for evaluation of liquidation policy and programs. Although progress has been made, we believe additional specific steps need to be taken to assure that liquidations are conducted at minimum cost to the fund.

Recommendations

The NCUA Board should

--reduce the standard for selling loan portfolios to no more than 45 days;

--establish a system for monitoring regional office compliance with policies intended to assure that liquidations take place at least cost to the fund; and

--keep records on assets, expenses, and net costs of individual liquidated credit unions, periodically summarizing them to monitor performance, identify trends, and pinpoint problems.

AGENCY COMMENTS

We solicited agency comments from the NCUA Board. The Board generally concurred with the conclusions and recommendations. They indicated the need to review the legal issues related to our recommendation that NCUA's Board should revise the priority of payments to place the insurance fund on an equal basis with general creditors. NCUA's response is presented in the appendix.

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As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the Senate Committee on Governmental Affairs and the House

Committee on Government Operations not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

Copies of this report are being sent to the Chairman, Senate Committee on Banking, Housing and Urban Affairs; Senate Committee on Appropriations; Senate Committee on Governmental Affairs; House Committee on Banking, Finance and Urban Affairs (Subcommittee on Financial Institutions, Supervision, Regulation, and Insurance); House Committee on Appropriations; and the House Committee on Government Operations (Subcommittee on Consumer, Commerce, and Monetary Affairs).

Sincerely yours,

W. J. Anderson

William J. Anderson
Director

Enclosure

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ENCLOSURE

ENCLOSURE

NATIONAL CREDIT UNION ADMINISTRATION
Washington, D.C. 20456

Office of the Board

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January 18, 1982

Mr. William J. Anderson
Director, General Government Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Anderson:

Reference is made to your letter of December 16, 1981, transmitting the draft report entitled: "NCUA Should Revise Liquidation Procedures to Reduce the Net Cost of Credit Union Liquidations."

We are in general concurrence with your recommendations, however, the following requires comment:

The NCUA Board should revise the priority of payments to place the insurance fund on an equal basis with general creditors.

This recommendation is currently under consideration. There are, however, certain substantive legal issues that are under review. If the issues can be resolved, NCUA will pursue implementation of the GAO recommendation.

In closing, I would like to thank you for the fine efforts of your staff, particularly Ms. Altenhofen, for the constructive approach taken in your review of our liquidation program.

Sincerely,

E. F. Callahan

E. F. CALLAHAN
Chairman, NCUA Board

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